Supreme Court, U.S.
FILED
SEP 17 2003
OFFICE OF THE CLERK

No. 02-1196

In the Supreme Court of the United States

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHARLES E. EDWARDS

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

REPLY BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

THEODORE B. OLSON
Solicitor General
Counsel of Record
Department of Justice
Washington, D.C. 20530-0001
(202) 514-2217

TABLE OF CONTENTS

	Page
A. The statutory text and purposes demonstrate that an "investment contract" may have a fixed or contractually guaranteed return	2
B. Precedent confirms that investment contracts may have fixed or contractually guaranteed returns	7
C. The SEC has consistently interpreted "investment contract" to include fixed- and guaranteed-return investments	15
D. Respondent's other arguments also lack merit	18

TABLE OF AUTHORITIES

Cases:

Abbett, Sommer & Co., In re, 44 S.E.C. 104 (1969)	16
Barack v. *United States*, 317 F.2d 619 (9th Cir. 1963)	7
Bell v. *Hood*, 327 U.S. 678 (1946)	2
Chevron U.S.A. Inc. v. *Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984)	15
Creasy Corp. v. *Enz Bros.*, 187 N.W. 666 (Wis. 1922)	6
Garcia v. *Copenhaver, Bell & Assoc., M.D.'s, P.A.*, 104 F.3d 1256 (11th Cir. 1997)	2
Gustafson v. *Alloyd Co.*, 513 U.S. 561 (1995)	6
Landreth Timber Co. v. *Landreth*, 471 U.S. 681 (1985)	2, 6
Lewis v. *Creasey Corp.*, 248 S.W. 1046 (Ky. 1923)	6
Los Angeles Trust Deed & Mortgage Exch. v. *SEC*, 285 F.2d 162 (9th Cir. 1960), cert. denied, 366 U.S. 919 (1961)	16
Marine Bank v. *Weaver*, 455 U.S. 551 (1982)	7, 12
Office of Personnel Management v. *Richmond*, 496 U.S. 414 (1990)	19

Cases—Continued: Page

People v. *White*, 12 P.2d 1078 (Cal. Dist. Ct. App. 1932) 4
Prohaska v. *Hemmer-Miller Dev. Co.*, 256 Ill. App. Ct. 331 (1930) 5
Reves v. *Ernst & Young*, 494 U.S. 56 (1990) 12, 13, 20
Saudi Arabia v. *Nelson*, 507 U.S. 349 (1993) 2
SEC v. *Bailey*, 41 F. Supp. 647 (S.D. Fla. 1941) 11
SEC v. *Bourbon Sales Corp.*, 47 F. Supp. 70 (W.D. Ky. 1942) 10-11
SEC v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943) 6
SEC v. *Culpepper*, 270 F.2d 241 (2d Cir. 1959) 19
SEC v. *Infinity Group Co.*, 212 F.3d 180 (3d Cir. 2000), cert. denied, 532 U.S. 905 (2001) 11
SEC v. *Payne*, 35 F. Supp. 873 (S.D.N.Y. 1940) 10
SEC v. *United Benefit Life Ins. Co.*, 387 U.S. 202 (1967) 11
SEC v. *Universal Serv. Ass'n*, 106 F.2d 232 (7th Cir. 1939), cert. denied, 308 U.S. 622 (1940) 9, 10
SEC v. *Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959) 12
SEC v. *W.J. Howey Co.*:
60 F. Supp. 440 (S.D. Fla.), aff'd, 151 F.2d 714 (5th Cir. 1945), rev'd, 328 U.S. 293 (1946) 8
151 F.2d 714 (5th Cir. 1945), rev'd, 328 U.S. 293 (1946) 7, 18
328 U.S. 293 (1946) 3, 5, 8, 9, 13, 18
SEC v. *Zandford*, 535 U.S. 813 (2002) 16
State v. *Evans*, 191 N.W. 425 (Minn. 1922) 5
State v. *Gopher Tire & Rubber Co.*, 177 N.W. 937 (Minn. 1920) 3-4
State v. *Heath*, 153 S.E. 855 (N.C. 1930) 6
Stevens v. *Liberty Packing Corp.*, 161 A. 193 (N. J. Ch. 1932) 4, 5
Tcherepnin v. *Knight*, 389 U.S. 332 (1967) 7, 12

Cases—Continued: Page

Teamsters v. *Daniel*, 439 U.S. 551 (1979) 13, 14
Union Home Loans, In re, 26 S.E.C. Dkt. 1346 (Dec. 16, 1982) 16
United Hous. Found., Inc. v. *Forman*, 421 U.S. 837 (1975) 12, 13
United States v. *Carman*, 577 F.2d 556 (9th Cir. 1978) 11
United States v. *Mead Corp.*, 533 U.S. 218 (2001) 16
Utah Power & Light Co. v. *United States*, 243 U.S. 389 (1917) 19
Williamson v. *Tucker*, 645 F.2d 404 (5th Cir.), cert. denied, 454 U.S. 897 (1981) 2

Statute:

Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(10) 7

Miscellaneous:

Applicability of the Securities Laws to Multi-Level Distributorships and Pyramid Sales Plans, SEC Release Nos. 33-5211 & 34-9387 (Nov. 30, 1971) 17
Louis Loss, *Securities Regulation*:
(1st ed. 1951) 8
Vol. I (2d ed. 1961) 8
2 Louis Loss & Joel Seligman, *Securities Regulation* (3d ed. rev. 1999) 8

In the Supreme Court of the United States

No. 02-1196

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

CHARLES E. EDWARDS

ON WRIT OF CERTIORARI
TO THE UNITED STATES COURT OF APPEALS
FOR THE ELEVENTH CIRCUIT

REPLY BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION

The court of appeals dismissed the complaint of the Securities and Exchange Commission (SEC) based on the erroneous conclusion that an investment is not an "investment contract" if it offers a fixed or contractually guaranteed return. Respondent fails in his efforts to reconcile that limitation with the text and purposes of the securities laws, the broad and flexible construction of "investment contract" repeatedly applied by this Court, and the SEC's longstanding interpretation. The most notable aspect of respondent's brief, however, is what it does *not* say. Respondent identifies no basis in the statutory text for distinguishing between fixed- and variable-return investments. He also offers no reason why Congress would have wanted to draw that distinction, and he does not attempt to square it with the purpose of the securities laws to protect purchasers of both fixed- and variable-return investments. In fact, the rule adopted by the court of appeals would create a serious gap in the protection provided by those laws be-

cause it would allow unscrupulous promoters to circumvent them merely by limiting the returns offered by their investment schemes to fixed or contractually guaranteed amounts, even though that limitation has no relationship to the need for the laws' protection.[1]

A. The Statutory Text And Purposes Demonstrate That An "Investment Contract" May Have A Fixed Or Contractually Guaranteed Return

Respondent acknowledges that the definition of "security" is broad and encompasses not only "stocks, bonds, and debentures" but also "more general categories of instruments, including 'investment contract.'" Br. 15. He also acknowledges that Congress included that "more general" term in order to cover "unusual instruments that did not fit squarely within one of the enumerated specific kinds of securities listed in the definition." *Ibid.* (quoting *Landreth Timber Co.* v. *Landreth*, 471 U.S. 681, 690 n.4 (1985)). And respondent does not dispute (Br. 18 n.11, 32) that the ordinary meaning of the term "investment contract" includes arrangements offering fixed or contractually guaranteed returns. See SEC Br. 17. He nonetheless argues that an "investment contract" is restricted to investments with variable returns. Indeed, he contends that an investment contract is limited to a *particular type* of variable-return investment—one with what he terms "the essential attributes" of "equity securities," specifically, "a return that varies with the success of the business of the common enterprise." Resp. Br. 21. That contention cannot be reconciled with the text or purposes of the securities laws.

1. Because the ordinary meaning of the statutory language does not support him, respondent seeks to ground his argument in this Court's conclusion in *SEC* v. *W.J. Howey Co.*, 328 U.S. 293 (1946), that Congress intended "investment contract" to have the same meaning in the federal securities laws as in the state Blue Sky Laws that predated them. Respondent argues (Br. 17-20) that pre-1933 cases interpreting the Blue Sky Laws limited the term "investment contract" to arrangements with a return that varied with the success of the overall enterprise. But, as the SEC's opening brief (at 18-19) demonstrates, the Blue Sky cases did *not* limit "investment contract" in that manner. On the contrary, "investment contract" had been "broadly construed by state courts so as to afford the investing public a full measure of protection." *Howey*, 328 U.S. at 298. That construction—which included any "contract or scheme for 'the placing of capital or laying out of money in a way intended to secure income or profit from its employment'"—encompassed investments with fixed returns and returns to which investors were contractually entitled. *Ibid.* (quoting *State* v. *Gopher Tire & Rubber Co.*, 177 N.W. 937, 938 (Minn.

---

[1] Respondent errs in contending (Br. 8-9 n.8) that the Court need not accept the allegations of the complaint. In *Saudi Arabia* v. *Nelson*, 507 U.S. 349 (1993), the Court identified the motion at issue as one "to dismiss the complaint" (*id.* at 351) "for lack of subject matter jurisdiction" (*id.* at 354) and ruled that the Court was required to assume the truth of the allegations. *Id.* at 351. Moreover, the court of appeals' decision here turned on its conclusion that the payphone arrangement did not involve a "security" and consequently there was no cause of action under the securities laws. Respondent's own cases confirm that, when an "attack on subject matter jurisdiction also implicates an element of the cause of action," the challenge is treated as an attack on the merits, and "the defendant is forced to proceed under Rule 12(b)(6)" (with the allegations of the complaint taken as true) unless the claim is "clearly immaterial or insubstantial." *Garcia* v. *Copenhaver, Bell & Assoc., M.D.'s, P.A.*, 104 F.3d 1256, 1261 (11th Cir. 1997) (quoting *Williamson* v. *Tucker*, 645 F.2d 404, 415-416 (5th Cir.), cert. denied, 454 U.S. 897 (1981)). See generally *Bell* v. *Hood*, 327 U.S. 678, 682 (1946).

1920)).[2] Indeed, two cases cited in *Howey* to illustrate the correct Blue Sky law interpretation involved fixed or contractually guaranteed returns. See *People* v. *White*, 12 P.2d 1078 (Cal. Dist. Ct. App. 1932); *Stevens* v. *Liberty Packing Corp.*, 161 A. 193 (N.J. Ch. 1932).

In arguing to the contrary, respondent misreads those cases. The investment in *White* did not, as respondent asserts, provide "a return in the form of * * * a share in expected capital appreciation" (Resp. Br. 19 & n.12) but instead promised a true fixed return that did not vary with the enterprise's profitability. The investment agreement stated that the investor had given the defendant "$5000 in cash, which is to be used by [the defendant] for investment only until the 30th day of October, A.D. 1930," on which date the defendant "agrees to pay" the investor "the sum of $7,500 * * * as principal and earnings" for the stated period. 12 P.2d at 1079. The agreement did not provide that the $7,500 was due only if the defendant's investments were successful. On the contrary, it specified that payment of a fixed amount was due on a date certain, and the court relied on that fact in holding that the arrangement was an investment contract. *Id.* at 1081 (noting that the contract "plainly provides" that the defendant "agrees to pay a specified sum on a specified date").

---

[2] Unable to deny that the terms of the definition of investment contract adopted in *Gopher Tire* and endorsed in *Howey* encompass both fixed- and guaranteed-return investments (see SEC Br. 11-12), respondent seeks (Br. 17-18) to limit the definition's scope to the particular facts of *Gopher Tire*. But the fact that the investment in *Gopher Tire* offered a return that varied in part with the profits of the enterprise (see 177 N.W. at 937-938) does not mean that every "investment contract" must offer such a return, and nothing in *Gopher Tire* or *Howey* supports engrafting that limitation onto the broad language of the "investment contract" definition.

In *Stevens*, one of two contracts held to be securities was an "absentee ownership agreement, called a lease," whereby an investor purchased rabbits for $175 and leased them back to the seller to breed; the seller's literature "guarantee[d]" to pay the purchaser $1 per rabbit for one-half the expected 112 offspring per year and "guarantee[d]" the number of offspring by promising to replace any barren or dead rabbits. 161 A. at 193-194. Noting that the company "guarantee[d]" to pay $1 per rabbit for 56 of the offspring and "guarantee[d]" that the investor's rabbits would produce sufficient offspring by providing replacements as necessary (*ibid.*), the court viewed the contract as "purport[ing] to secure" a fixed return of "$56 a year upon a $175 investment" (*id.* at 195). The promotional materials described the arrangement as offering "32 per cent." "profit" on the $175, and the court characterized that offer as a "guaranty of 32 per cent. income per annum" on the amount invested. *Id.* at 194.

Other state cases cited in *Howey*, 328 U.S. at 298 & n.4, as demonstrating the pre-1933 state-law interpretation of "investment contract" likewise involved schemes promising returns that did *not* vary according to the profitability of the overall enterprise. See *State* v. *Evans*, 191 N.W. 425, 426-427 (Minn. 1922) (installment land sale allowing purchaser to obtain a refund of his payments with a "bonus" of "$70 for each $1,000," or, under certain conditions, to use his total payments plus "interest" for other purposes); *Prohaska* v. *Hemmer-Miller Dev. Co.*, 256 Ill. App. Ct. 331, 338-339 (1930) (land sale in which profits from seller's cultivation of purchaser's individual land, not a share of the profits of any larger operation, were applied to remainder of purchase price). Because those schemes would not qualify as investment contracts under respondent's interpretation, this Court's citation of them as exam-

ples of investment contracts demonstrates the error of respondent's position.[3]

2. Respondent does not dispute the SEC's contention (SEC Br. 20-21, 40-42) that limiting "investment contract" to variable-return investments would create a gap in the coverage of the securities laws. See Resp. Br. 44. Instead, he argues (*id.* at 29-31) that the term "investment contract" is not intended to serve as a "catch-all" to plug gaps in statutory coverage. That argument, however, is belied by this Court's recognition in *Howey*, *Landreth*, and *SEC* v. *C.M. Joiner Leasing Corp.*, 320 U.S. 344 (1943), that Congress intended "investment contract" to be a broad, flexible term covering "[n]ovel, uncommon, or irregular devices" (*id.* at 351) that "d[o] not fit squarely within one of the enumerated specific kinds of securities listed" (*Landreth*, 471 U.S. at 690 n.4). Although those cases do not expressly label "investment contract" as a "catch-all," they describe the term as having that function, which is consistent with its broad and general language.

Respondent further errs in his related argument that "investment contract" cannot include fixed-return securities because other terms in the definition of security would then be "redundant." Resp. Br. 30 (quoting *Gustafson* v. *Alloyd Co.*, 513 U.S. 561, 574 (1995)). This Court has held that the terms in the definition overlap, and an interest may be an "investment contract" yet

[3] The Blue Sky cases cited by respondent in which the courts declined to find investment contracts also do not support his position. Those cases turned not on the presence of a fixed return but on the fact that the contract holders were not passive investors and instead were required to devote their own efforts to produce the anticipated profits. See *State* v. *Heath*, 153 S.E. 855, 858 (N.C. 1930); *Lewis* v. *Creasey Corp.*, 248 S.W. 1046, 1049 (Ky. 1923). See also *Creasy Corp.* v. *Enz Bros.*, 187 N.W. 666 (Wis. 1922) (contract identical to the one in *Lewis*).

also come within one or more of the other terms. See *Tcherepnin* v. *Knight*, 389 U.S. 332, 339-340 (1967). Respondent also mistakenly suggests (Br. 30) that the term "evidence of indebtedness" is an adequate catch-all for unusual fixed-return securities. That term is not even included in the definition of security in the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(10), and some courts have suggested that the term is limited to written instruments, see *Barack* v. *United States*, 317 F.2d 619, 622 (9th Cir. 1963).[4]

B. Precedent Confirms That Investment Contracts May Have Fixed Or Contractually Guaranteed Returns

1. Respondent's narrow understanding of "investment contract" is also unsupported by precedent. Respondent incorrectly argues (Br. 16-17, 20-21) that the Court's holding in *Howey* depended on a determination that the citrus grove packages offered "a return which would vary based on the success of the business." *Id.* at 21. To the contrary, the returns of the *Howey* investors did not vary with the success of the overall enterprise. Rather, each investor "looked for the income from his investment to the fruitage of his own grove and not to the fruitage of the groves as a whole." *SEC* v. *W.J. Howey Co.*, 151 F.2d 714, 717 (5th Cir. 1945), rev'd, 328 U.S. 293 (1946). A grove might have no "fruitage" for

[4] Respondent is also incorrect in arguing (Br. 1, 32) that coverage of his payphone offerings under the securities laws is not necessary because they may be subject to regulation by the Federal Trade Commission (FTC). FTC regulation would not make the disclosure and antifraud protections of the securities laws unnecessary because FTC disclosure requirements are not aimed at reducing, and do not reduce, the risk that ETS might become insolvent and unable to pay investors their promised returns. Cf. *Marine Bank* v. *Weaver*, 455 U.S. 551, 557-558 (1982); pp. 11-12, *infra*.

several years because only some of the groves were planted with trees that were already "bearing." *SEC* v. *W.J. Howey Co.*, 60 F. Supp. 440, 441 (S.D. Fla.), aff'd, 151 F.2d 714 (5th Cir. 1945), rev'd, 328 U.S. 293 (1946); see also 328 U.S. at 295 (price per acre depended on age of trees). In addition, each investor paid the cost of care for his own grove. "In the care of each grove, as in the yield of the fruit, the costs of the care, and the proceeds of the fruit, * * * [we]re definitely and distinctly accounted for with respect to the specific property owned by the individual." 151 F.2d at 716 n.5; see 60 F. Supp. at 441. Indeed, the absence of a right to a share in the profits of an overall enterprise was among the reasons the *Howey* court of appeals concluded that the interests were *not* investment contracts. 151 F.2d at 717. This Court reversed, necessarily rejecting that reasoning. *Howey* was thus not a case in which each investor received a pro rata share of the profits of the whole orchard based on either the amount of land he owned or the amount of money he invested.[5] Accordingly, *Howey* refutes respondent's contention that an investment contract exists only when each investor's return varies with overall profits.[6]

[5] Respondent relies (Br. 31) on a statement in 2 Louis Loss & Joel Seligman, *Securities Regulation* 951 (3d ed. rev. 1999), that refers to the investment contract test in *Howey* as a test designed to capture "equity" interests, which respondent assumes are equivalent to investments that offer a share of the profits of the overall enterprise. Earlier editions of Professor Loss's treatise, however, specifically recognized that the *Howey* test encompasses other arrangements, and collected cases in which an investment contract was present "without any element of pooling or profit-sharing among different investors." See I Louis Loss, *Securities Regulation* 489 & n.86 (2d ed. 1961); Louis Loss, *Securities Regulation* 318-319 & n.39 (1st ed. 1951) (same).

[6] Although the issue is not before the Court, *Howey* also refutes respondent's contention (Br. 34 n.18) that an investment contract must demonstrate "horizontal commonality"—a correlation among the profits of individual investors. Because the profits of each *Howey* investor depended on the yield and costs of the investor's own plot, investors' returns were independent of one another. Even if "horizontal commonality" is required, however, it is present here. Each payphone investor expected to receive his contractually specified return not from the earnings of his individual phone, but from the earnings of the overall venture. An investor's funds were not segregated and used to maintain only his particular phone, but were pooled to operate the overall payphone enterprise. Moreover, ETS's ability to meet its obligations to existing investors was dependent on its ability to bring in new investors. Thus, investors were dependent on one another for their returns.

Howey also cited several federal court decisions as correctly applying the broad interpretation of "investment contract" that this Court was adopting. 328 U.S. at 299 n.5. As noted in the SEC's opening brief (at 24, 31), one of those cases—*SEC* v. *Universal Serv. Ass'n*, 106 F.2d 232 (7th Cir. 1939), cert. denied, 308 U.S. 622 (1940)—involved a scheme offering a fixed return. Contrary to respondent's contention (Br. 42, 47), the return in *Universal* was *not* contingent on the promoters' profits. Upon payment of "$1.00 per month for five years" ($60), each investor was promised title to a farm "worth $150" or that amount in cash, which represented a return of "30% per annum profit." 106 F.2d at 234. The investor's contribution was used in the promoters' agricultural enterprises, but the 30% return was not dependent on earnings from those enterprises, and nothing prevented the promoters from using other sources to pay the promised return.[7]

[7] It would thus make no difference if, as respondent suggests (Br. 5), he did not represent that the "lease" payments would come specifically from ETS's payphone operations. It is, however, clear that investors were led to believe that their returns would come from that source. As discussed at pp. 14-15, *infra*, the promotional

Indeed, the court of appeals emphasized that the scheme offered "*assured* profit of 30% per annum with *no chance of risk or loss to the contributor.*" *Universal*, 106 F.2d at 234 (emphasis added). Moreover, that guaranteed return was represented to investors as a percentage of the amount they paid in, not a percentage of the earnings of the enterprise. See *ibid.* *Howey*'s endorsement of *Universal* thus confirms that an investment contract may have a fixed, contractually guaranteed return that is not linked to the profits of the overall enterprise.

Three other cases cited with approval in *Howey* also involved arrangements that would be excluded from the "investment contract" category under respondent's interpretation because the investors' returns did not vary with the profits of the overall enterprise. For example, in *SEC* v. *Payne*, 35 F. Supp. 873 (S.D.N.Y. 1940), each investor in the fox-breeding scheme received the profits from the sale of his own specifically identified foxes. *Id.* at 875. Contrary to respondent's assertion that there was a "pro-rata sharing in the profits" (Br. 37 n.21), the court expressly noted that the scheme had been modified to "eliminate[] * * * the pooling of foxes * * * and * * * the pro rata distribution" of the overall proceeds. 35 F. Supp. at 875. The court nonetheless held the scheme to be an investment contract. *Id.* at 877-878. Likewise, in *SEC* v. *Bourbon*

materials, including ETS's website, touted ETS's profitable operation of payphones and made no mention of any other businesses operated by the company. Further, respondent admits (Br. 7 n.6) that he wrote a letter on July 1, 2000 (J.A. 229-230), in which he responded to "questions from our Lessors" about the profitability of ETS's payphone operations. "Lessors" would likely have been concerned about the profitability of those operations because they expected ETS's payphone earnings to fund their monthly "lease" payments, as the promotional materials suggested.

Sales Corp., 47 F. Supp. 70, 71 (W.D. Ky. 1942), and *SEC* v. *Bailey*, 41 F. Supp. 647, 649 (S.D. Fla. 1941), each investor appears to have received profits from only his own specific property.[8]

2. This Court's post-*Howey* decisions also do not support respondent's contention that investment contracts must offer returns that vary with the profits of the overall enterprise. In *SEC* v. *United Benefit Life Insurance Co.*, 387 U.S. 202 (1967), the Court held the pre-maturity portion of a deferred annuity plan to be an investment contract, even though that portion of the plan offered, as one of two alternative returns, a "guarantee of cash value based on net premiums." *Id.* at 211. See SEC Br. 26-27. Respondent thus misreads *United Benefit* in contending (Br. 21-22) that the portion of the annuity held to be an investment contract offered only a variable return. The guarantee included in that portion of the annuity set a floor below which the investor's return did *not* vary with the profits of the enterprise. *United Benefit* thus confirms that "investment contract" is not limited in the way respondent claims.

[8] Respondent disputes (Br. 37-41) the SEC's reliance (Br. 27-29) on two court of appeals decisions holding that investment contracts may promise fixed returns: *SEC* v. *Infinity Group Co.*, 212 F.3d 180 (3d Cir. 2000), cert. denied, 532 U.S. 905 (2001), and *United States* v. *Carman*, 577 F.2d 556 (9th Cir. 1978). He concedes that the cases so held but claims that the holdings have no bearing here because "both courts were addressing the 'common enterprise' element of *Howey* and not the 'profits from the efforts of others' element." Resp. Br. 38. It does not matter, however, what aspect of the *Howey* description of "investment contract" those courts were addressing. Pet. Reply 7-8. Both held, contrary to the court of appeals here, that a fixed return does not exclude an investment from the statutory term.

Respondent's reliance on other decisions of this Court is likewise misplaced. Several involved insurance or bank products, which are subject to other regulatory regimes aimed at ensuring the solvency of the entity issuing the product. See *Marine Bank*, 455 U.S. at 557; *Tcherepnin*, 389 U.S. at 337; cf. *SEC* v. *Variable Annuity Life Ins. Co.* (*VALIC*), 359 U.S. 65, 69-70 (1959). If the return offered by such products is fixed, and purchasers thus are dependent only on the issuer's solvency, the protections of the securities laws may be unnecessary because the separate regulatory scheme directly protects against the risk of insolvency. See Br. for the U.S. as Amicus Curiae at 10-15, *Marine Bank*, *supra* (No. 80-1562); *VALIC*, 359 U.S. at 77-78 (Brennan, J., concurring). In *Tcherepnin*, however, where investors were dependent on factors other than the bank's solvency, the interests were held to be securities. In none of those cases did the Court suggest that a fixed return might preclude an arrangement from being an investment contract even where, as here, no separate regulatory regime protects investors against the risk of the issuer's insolvency.[9]

Nor, contrary to respondent's claims (Br. 23, 26-27), do this Court's decisions in *United Housing Foundation, Inc.* v. *Forman*, 421 U.S. 837 (1975), and *Reves* v. *Ernst & Young*, 494 U.S. 56 (1990), restrict the meaning

[9] Decisions of four courts of appeals involving commercial bank "loan participations," relied on by respondent (Br. 36), mention a fixed return as a factor in the determination that the products sold were not investment contracts. As discussed in the SEC's opening brief (at 30 n.11), however, those products were not investment contracts because of their commercial, rather than investment, nature. Contrary to respondent's contention, the context in which the products were sold (*e.g.*, to whom and for what purpose) is clearly relevant to whether they were investment contracts. See *Marine Bank*, 455 U.S. at 560 n.11.

of "profits" under *Howey*'s definition of "investment contract" to variable returns. *Reves*, as respondent acknowledges, "did not purport to alter the meaning of 'profits' from its use in *Howey*" (Resp. Br. 27) but only to mention in passing how the Court had previously construed "profits" in *Forman*. See SEC Br. 36-37. That passing reference in a footnote, which was "irrelevant" to the Court's holding in *Reves* (494 U.S. at 68 n.4), was simply not (and was plainly not intended to be) a precise or comprehensive definition of "profits" for purposes of the *Howey* test. Nor did *Forman* itself limit the meaning of "profits" to variable returns. Indeed, the SEC's opening brief (at 35-36) identifies several statements in *Forman* that indicate that the Court understood "profits" to have its ordinary broad meaning, which encompasses fixed returns. For example, the Court equated "profits" with "financial returns" and with "income or profits," 421 U.S. at 853, 855, terms that plainly include fixed returns such as interest or rent (see SEC Br. 35-36). Respondent ignores those statements in *Forman* and merely quotes other snippets that might—read out of context—support a limitation to variable returns, but that in context do not, as the SEC's opening brief (at 34-35) demonstrates. The correct test, the Court summarized in *Forman*, is whether "the investor is 'attracted solely by the prospects of a return' on his investment" (421 U.S. at 852 (citing *Howey*, 328 U.S. at 300)), rather than a desire to use or consume a purchased item (*id.* at 853). That test is clearly satisfied here.[10]

[10] *Teamsters* v. *Daniel*, 439 U.S. 551 (1979) (cited at Resp. Br. 24) also provides respondent no support. The Court held that there was no investment contract in *Daniel* because the pension benefits depended primarily on the employee's efforts to meet the vesting requirements, not on the investment success of the retire-

3. Respondent also argues (Br. 3, 32-33) that the payphone investment packages are not investment contracts under the principle (reflected in *Joiner* and *United Benefit*) that promoters are held to the representations that they make to prospective purchasers. See SEC Br. 25-26. Respondent claims that he did not represent that prospective investors would receive "profits" from their payphone packages. But the SEC's complaint alleged that the promotional materials made such representations (J.A. 13), and that is sufficient to preclude dismissal. In any event, the evidence presented at the preliminary injunction hearing fully supports the complaint's allegations. The promotional materials, including ETS's brochure describing the lease program, referred to "profits" for "owners" of payphones. See SEC Br. 4; Pet. Reply 5 n.3; J.A. 100-102, 114-115, 117-120, 124. And ETS's publicly available website represented that "profitable opportunities" were available in the payphone industry and "pay phone owners" could expect to receive "profits" through ETS. See J.A. 223 ("pay phone owner" could "maximize[]" "profits" through "management expertise provided by ETS Payphones"); J.A. 227 ("profits for individual pay phone owners"; "pay phone industry has grown into a highly profitable venture"; "pay phone ownership offers a unique business environment"); J.A. 228 ("millions to be made from owning pay phones").

Respondent attempts (Br. 3, 32-33) to distance himself from the representations about "profits" contained in brochures and websites of the "distributors." But respondent admitted that he saw the brochures used by the distributors and knew that they marketed the

ment fund. 439 U.S. at 561. The linchpin of the Court's analysis was that the employee's return depended on his *own* efforts rather than the "efforts of others" as in *Howey*.

phone packages with a document "similar" to a brochure used by ETS, which he himself had designed. J.A. 48-49. Although respondent contends (Br. 33) that the ETS brochure was not "directed" to payphone owners, the brochure repeatedly refers to "profits" for payphone "owners" to be derived from ETS's management of the phones. J.A. 114-120. Further, respondent has never disputed that he recorded payphone sales revenues as income to ETS (see J.A. 45) and that, under the leases, ETS contracted to refund to each investor, upon request, the full purchase price the investor had paid to the distributor for the "payphone equipment and location" (J.A. 129). Respondent cannot seriously dispute that he is responsible for the representations made in the marketing materials.

C. The SEC Has Consistently Interpreted "Investment Contract" To Include Fixed- And Guaranteed-Return Investments

Respondent is also wide of the mark in arguing (Br. 44-49) that the SEC has not been consistent in its position that investment contracts may have fixed or guaranteed returns and that the SEC's interpretation is not entitled to deference. As early as 1936, the SEC took the position in an enforcement action that a fixed-return investment was an "investment contract," see p. 9, *supra* (discussing *SEC* v. *Universal Serv. Ass'n)*, and it has not wavered in that view. Its longstanding position, embodied in a variety of forms, including formal adjudications, is entitled to deference. SEC Br. 31-33.[11]

[11] Respondent errs in arguing (Br. 44-45) that deference under *Chevron U.S.A. Inc.* v. *Natural Resources Defense Council, Inc.*, 467 U.S. 837 (1984), is barred by stare decisis because this Court's decisions in *Forman* and *Reves* removed any ambiguity about whether the term "investment contract" includes fixed-return investments. As explained at pp. 12-13, *supra*, *Forman* and *Reves* did not involve or purport to resolve the question whether a fixed-

For example, *Los Angeles Trust Deed & Mortgage Exchange* v. *SEC*, 285 F.2d 162 (9th Cir. 1960), cert. denied, 366 U.S. 919 (1961), *In re Abbett, Sommer & Co.*, 44 S.E.C. 104 (1969), and *In re Union Home Loans*, 26 SEC Dkt. 1346 (Dec. 16, 1982), involved investment contracts comprised of mortgage notes coupled with services performed by the promoters. In all those cases, the investors' returns were fixed amounts—interest on the notes that were part of the packages. Respondent's contention that *Abbett* did not involve a fixed return because the *services* the promoter performed "were directed essentially toward minimizing the risk involved in the investment" (Br. 48 (quoting *Abbett*)) makes no sense. The investors' returns were the fixed interest amounts they expected to receive on the mortgage notes. Although the notes might not have been investment contracts if they had not been packaged with the services, the services (whatever their nature) did not transform the investors' expected returns into variable amounts. Both *Abbett* and *Union Home Loans* were formal adjudications, and the long-standing interpretation of "investment contract" reflected therein is therefore entitled to *Chevron* deference. See *SEC* v. *Zandford*, 535 U.S. 813, 819-820 (2002) (citing *United States* v. *Mead Corp.*, 533 U.S. 218, 229-231 (2001)).[12]

---

return investment may be an "investment contract," and the SEC's interpretation that it may, which dates from at least 1936 and is embodied in a 1969 adjudication, predates both *Forman* and *Reves*.

[12] As noted in the petition reply (at 9), the fact that the subject of the SEC's order in *Union Home Loans* did not contest the charges did not render the proceeding something other than an adjudication entitled to *Chevron* deference. In any event, *Union Home Loans* did not announce a new position, but reiterated the SEC's interpretation in *Abbett*, a contested case.

Respondent also errs in asserting (Br. 47-48) that the SEC release, *Applicability of the Securities Laws to Multi-Level Distributorships and Pyramid Sales Plans*, SEC Release Nos. 33-5211 & 34-9387 (Nov. 30, 1971), is inconsistent with the SEC's argument here and suggests that an "investment contract" must be an equity interest. Although the release assumed that *Howey* itself "described an investment contract providing the investor with an equity interest" (*id.* at 3), nothing in the release's *Howey* discussion suggests that investment contracts are *limited* to equity interests or that they exclude fixed-return investments. In fact, the release made the opposite point, stating that it is not "significant that the return promised for the use of an investor's money may be something other than a share of the profits of the enterprise," and that, "where the interest offered is of a different nature" than in *Howey*, *i.e.*, *not* an equity interest, "the promised return will necessarily vary," *i.e.*, "may be something other than a share of the profits of the enterprise." *Ibid.*

The release specifically identified "cash fees" for "the recruitment of additional participants" as one form of return offered in the pyramid sales schemes that the SEC considered to be investment contracts. SEC Release Nos. 33-5211 & 34-9387, at 4. Although the return in such schemes is not a fixed sum, because the total amount varies with the number of new victims each investor finds, the investor's return does *not* vary with the overall earnings of the enterprise, as respondent insists is required for an investment contract to exist. Thus, the release is consistent with the SEC's argument here, and with its interpretation in the adjudications and enforcement actions that have deemed "investment contract" to include fixed-return schemes.

D. Respondent's Other Arguments Also Lack Merit

Respondent also proffers various other objections to classifying the payphone arrangements as investment contracts. None is persuasive. Respondent contends (Br. 2, 49) that two separate companies, both wholly owned by him, carried out different parts of the payphone business. But *Howey* likewise involved two separate companies and two separate contracts. 328 U.S. at 294-295. The division of tasks did not remove the interests in *Howey* from the scope of investment contract, and it does not do so here. Respondent also contends (Br. 5-6) that the investors' payphones had intrinsic value and investors could take possession of them if ETS failed to make the lease payments. But that fact, if true, is also irrelevant. In *Howey*, the promoters sold fee simple interests in specific strips of land along with the service contracts (328 U.S. at 293, 299), but that did not preclude the existence of an investment contract. See *id.* at 301 ("it is immaterial * * * whether there is a sale of property with or without intrinsic value"). Respondent also notes (Br. 4, 6) that investors were not required to use ETS to manage their phones. In *Howey*, however, investors likewise were not required to use the promoters' service company, and 15% of them did not do so. 328 U.S. at 295. "[A]t least seven" other companies were available to perform similar services. 151 F.2d at 716 n.5.[13]

[13] Contrary to respondent's suggestion (Br. 4), at least one of the payphone packages that he offered in addition to the lease program was almost certainly also an investment contract. "Option II," under which a phone purchaser paid ETS fees to perform all phone management functions and received the net profits from his phone (J.A. 127-128), is analogous to the investment contracts in *Howey* (see 328 U.S. at 296; 151 F.2d at 716 n.5, 717). The SEC did not include Option II in its complaint because 99% of phone purchasers chose Option III, the lease program. See J.A. 164.

Finally, respondent incorrectly implies (Br. 2, 49) that the payphone interests should not be held to be securities because he purportedly structured the business in accordance with advice that an SEC attorney gave him in 1995. The record refutes respondent's claim of reliance (J.A. 61-64, 160), and, in any event, a government attorney's alleged promise not to take enforcement action would not bind the SEC in its interpretation of the securities laws. See *Utah Power & Light Co.* v. *United States*, 243 U.S. 389, 408-409 (1917) (cited with approval in *Office of Personnel Management* v. *Richmond*, 496 U.S. 414, 420 (1990)); *SEC* v. *Culpepper*, 270 F.2d 241, 248 (2d Cir. 1959).[14]

* * * * *

Respondent sold the payphone packages to raise capital to operate his business. See SEC Br. 3, 13; J.A. 158. He promoted them as passive investments through which investors could obtain "profits," and investors entrusted their money to him for that purpose. See SEC Br. 3-4; pp. 14-15, *supra*. Those investment agreements are precisely the kind of arrangements that Congress sought to regulate as securities under the federal securities laws. They fall squarely within the term "investment contract," the broad and general language of which is designed to cover unusual arrangements that do not fit comfortably within one of the enumerated specific kinds of securities. They fall squarely within the meaning the term "investment contract" had

[14] Respondent also relies (Br. 49) on the SEC attorney's purported advice to bolster his claim (see pp. 15-17, *supra*) that the SEC has been inconsistent in its position that an investment contract may have a fixed return. But the advice he claims the attorney gave him—to separate the operation into two companies—has nothing to do with the fixed nature of the return and is not inconsistent with any SEC interpretation on that issue.

acquired under the Blue Sky laws that served as the model for the federal securities laws. And they fall squarely within the meaning that term has been given by the SEC and the courts in the 70 years since those laws were enacted.

Respondent's proposal to limit the scope of "investment contract" to investments offering a return that varies with the profits of the overall enterprise is a radical departure from the enforcement history of the securities laws. The limitation that he proposes would deny "the SEC and the courts sufficient flexibility to ensure that those who market investments are not able to escape the coverage of the Securities Acts by creating new instruments that" fall outside the rigid per se rule he proposes. *Reves*, 494 U.S. 56, 63 n.2. Indeed, respondent's proposed rule, like the court of appeals' decision, provides a blueprint for unscrupulous promoters to circumvent the securities laws simply by structuring the returns offered by their investment schemes as fixed or guaranteed amounts. That result would frustrate Congress's intent "to regulate *investments*, in whatever form they are made and by whatever name they are called," *id.* at 61, and it should not be sanctioned by this Court.

For the reasons stated above and in the SEC's opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

THEODORE B. OLSON
Solicitor General

SEPTEMBER 2003